

A11-1014

STATE OF MINNESOTA

IN SUPREME COURT

444 Lafayette, LLC
and
Meritex Enterprises, Inc.,

Relators,

v.

County of Ramsey,

Respondent.

RESPONDENT'S BRIEF

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Table of Contents

LEGAL ISSUES	1
I. Whether the Tax Court determined the value of the Subject Property based on facts presented in the record	1
II. Whether the Tax Court adequately explained the reasoning behind its decisions	1
III. Whether the Tax Court misvalued the Subject Property in light of its determination of value for a prior year	2
STATEMENT OF THE CASE	3
STATEMENT OF FACTS	4
ARGUMENT	8
I. Standard of Review	8
II. The Tax Court’s valuation should be affirmed 1) because it was based on the evidence, 2) because the Tax Court adequately explained its findings, and 3) because the Subject Property was not misvalued.	9
1. The Tax Court’s findings were based on evidence presented by the appraisers and the court explained every step of its decision making process	10
1.1. The Tax Court did not err in finding Messner’s analysis of market rent more persuasive	12
1.2. The Tax Court did not err when it included income derived from parking.	13
1.3. The Tax Court did not err when it adopted Messner’s analysis for market vacancy and expenses	17
1.4. The Tax Court did not err when it excluded TIs from NOI.	18

1.5. The Tax Court did not err by choosing a capitalization rate that accurately reflected the comparative data and the unique features of the Subject Property’s submarket.....	22
2. Despite the difference between the current and prior Tax Court valuations, there is no evidence that shows the Tax Court misvalued the Subject Property.....	26
2.1. Messner’s sales comparison approach supported the Tax Court’s determinations of the Subject Property’s value.....	26
2.2. The Tax Court’s prior valuations for a prior year are not persuasive evidence of the Subject Property’s current value....	28
2.3. The Tax Court appropriately considered the 2007 sale price but did not rely on it for its determinations of value.	30
CONCLUSION	31
CERTIFICATION OF BRIEF LENGTH.....	32

Table of Authorities

Minnesota Statutes

Minnesota Statutes Section 271.10, subdivision 1 (2010).....1, 2

Minnesota Cases

Alvin v. Johnson, 63 N.W.2d 22 (Minn. 1954)..... 14

Continental Retail, LLC v. Cnty of Hennepin, --- N.W.2d ---, No. A11-0345, 2011 WL 3586180 (Minn. Aug. 17, 2011).....8, 9

Eden Prairie Mall v. Cnty. of Hennepin, 797 N.W.2d 186
(Minn. 2011)..... *Passim*

Equitable Life Assurance Soc’y of U.S. v. Cnty. of Ramsey, 530 N.W.2d 544
(Minn. 1995)..... *Passim*

Kmart Corp. v. Cnty. of Becker, 709 N.W.2d 238 (Minn. 2006)..... 10, 15

Meritex v. Cnty. of Ramsey, No. CX-06-4506, 2009 WL 2366285 (Minn.
Tax Ct. July 24, 2009) 29

SLC TB Acquisition L.L.C. v. Cnty. of Murray, Nos. C2-03-121, C4-03-248,
2004 WL 1459339 (Minn. Tax Ct. June 15, 2004) 2, 21, 28

Weed v. Cnty. of Fillmore, 630 N.W.2d 419 (Minn. 2001) 15, 18, 30

Other Authorities

Appraisal Institute, The Appraisal of Real Estate (13th ed. 2008)..... *Passim*

LEGAL ISSUES

I. Whether the Tax Court determined the value of the Subject Property based on facts presented in the record.

The Tax Court was presented with an appraisal report and testimony from Relators' appraiser, Mr. Amundson, and with an appraisal report and testimony from Respondent's appraiser, Mr. Messner. These appraisers arrived at different conclusions regarding the value of the property at 444 Lafayette Road in St. Paul, Minnesota ("Subject Property"). The Tax Court determined that Messner's appraisal was more persuasive, though it also added parking income derived from the contract rents as presented in Amundson's report. The Tax Court's rulings in these regards were in accordance with the law and with proper real estate appraisal techniques.

Relators have preserved this issue for appeal by petitioning the Supreme Court for certiorari pursuant to Minn. Stat. § 271.10, subdiv. 1 (2010).

The most apposite cases are Eden Prairie Mall v. Cnty. of Ramsey, 797 N.W.2d 186 (Minn. 2011) and Equitable Life Assur. Soc. Of U.S. v. Cnty. of Ramsey, 530 N.W.2d 544 (Minn. 1995).

II. Whether the Tax Court adequately explained the reasoning behind its decisions.

Throughout its Order, the Tax Court explained which appraisal report it was using to derive its calculations, as well as explaining why it chose one report over another. When the Tax Court arrived at a calculation not presented in either report, it explained how it applied proper real estate appraisal techniques to evidence presented in the record in order to arrive at its conclusion.

Relators have preserved this issue for appeal by petitioning the Supreme Court for certiorari pursuant to Minn. Stat. § 271.10, subdiv. 1 (2010).

The most apposite cases are Eden Prairie Mall v. Cnty. of Ramsey, 797 N.W.2d 186 (Minn. 2011) and Equitable Life Assur. Soc. Of U.S. v. Cnty. of Ramsey, 530 N.W.2d 544 (Minn. 1995).

III. Whether the Tax Court misvalued the Subject Property in light of its determination of value for a prior year.

The Tax Court examined its prior ruling on the Subject Property and found that the prior ruling was not persuasive because of significant renovations made to the Subject Property and a strengthening office market in the Twin Cities subsequent to the assessment date at issue in the prior case. In addition, the Tax Court analyzed alternate appraisal methods used by both experts to ensure it had not misvalued the property. Finally, the Tax Court examined the Subject Property's 2007 sale price, though this was not determinative to its findings.

Relators have preserved this issue for appeal by petitioning the Supreme Court for certiorari pursuant to Minn. Stat. § 271.10, subdiv. 1 (2010).

The most apposite cases are Eden Prairie Mall v. Cnty. of Ramsey, 797 N.W.2d 186 (Minn. 2011); Equitable Life Assur. Soc. Of U.S. v. Cnty. of Ramsey, 530 N.W.2d 544 (Minn. 1995); and SLC TB Acquisition L.L.C. v. Cnty. of Murray, Nos. C2-03-121, C4-03-248, 2004 WL 1459339 (Minn. Tax Ct. June 15, 2004).

STATEMENT OF THE CASE

This case involves a dispute over the market value of the Subject Property for the 2007, 2008 and 2009 assessments for determining property taxes payable in 2008, 2009 and 2010. The Ramsey County Assessor had estimated the value of the Subject Property to be \$22,500,000 for each of those years. Relators petitioned the Tax Court to lower the value of the Subject Property and the Honorable Sheryl A. Ramstad, Judge of the Minnesota Tax Court, heard this matter on December 6, 7, 15, and 22, 2010.

Relators and Respondent presented expert appraisers to testify as to the value of the Subject Property on the assessment dates at issue. Within his reports and during his testimony, Amundson testified that the Subject Property was worth \$16,600,000 on January 2, 2007, \$16,300,000 on January 2, 2008, and \$13,800,000 on January 2, 2009. Amundson included income from parking in his analysis and deducted tenant improvements and leasing costs from the net operating income (NOI). Messner testified that the Subject Property was worth \$23,900,000 on January 2, 2007, \$25,000,000 on January 2, 2008, and \$21,000,000 on January 2, 2009. Messner factored tenant improvements into his estimate of the capitalization rate instead of deducting them from the NOI. Also, Messner did not include parking income in his

analysis. The appraisers differed on their estimations of market rents, market vacancy, leasing costs, and the appropriate capitalization rates.

The Tax Court relied primarily on the income approach and, for the most part, found Messner's estimates by that approach to be more persuasive. The Tax Court, however, included parking income when determining NOI for the Subject Property using contract rates for parking as listed in Amundson's report. In doing so, the Tax Court concluded that the value of the Subject Property was \$26,164,000 on January 2, 2007, \$27,420,000 on January 2, 2008, and \$22,094,000 on January 2, 2009.

Relators have since requested review of this decision and have been granted certiorari.

STATEMENT OF FACTS

This case addresses the value of an office property located at 444 Lafayette Road in St. Paul, Minnesota. The Subject Property has a gross building area of 329,711 square feet.¹ Of that, 250,695 square feet are rentable office space and 29,477 square feet are rentable storage space.²

The Subject Property has been used as office space since 1986 and, during that entire time, has been leased to the State of Minnesota.³ In 2005,

¹ Resp't Ex. I, p. 32.

² Id.

³ Relators' Ex. 1, p. 2; Resp't Ex. I, p.1.

Relators executed a ten-year lease with the Department of Human Services.⁴ As part of the negotiation over this lease, Meritex agreed to remodel the Subject Property at a cost of almost \$13,000,000 over the course of 2005, 2006, and 2007.⁵ In December 2007, Meritex sold the Subject Property, along with several parking parcels, to 444 Lafayette, LLC for \$36,000,000.⁶

To determine the taxes payable in 2008, 2009, and 2010, the Ramsey County Assessor estimated the Subject Property's value to be \$22,500,000 for the 2007, 2008, and 2009 assessments. Relators requested that the Minnesota Tax Court review these assessments. On December 6, 7, 15, and 22, 2010, the Minnesota Tax Court held a trial wherein Relators and Respondent presented appraisals and testimony from their appraisers regarding the value of the Subject Property.

Though they used various appraisal methods, both appraisers relied primarily on the income capitalization method as the most accurate method for determining the value of the Subject Property.⁷ This method involves determining the net operating income ("NOI") of a given property and then dividing it by the appropriate capitalization rate.⁸ The appraisers differed,

⁴ Relators' Ex. 1, p. 3; Resp't Ex. I, p.76.

⁵ Id.; Relator's Addendum ("RA") Add-06.

⁶ Relators' Ex. 1, p.3, RA Add-07.

⁷ Relators' Ex. 1, p. 48; Resp't Ex. I, pp. 115-16.

⁸ Resp't Ex. I, p. 75.

however, in their calculations of the Subject Property's NOI as well as the applicable capitalization rate.

In determining the NOI of the Property, Amundson and Messner differed in their calculations of market rent, market vacancies, and market expenses. Also, Amundson included parking income derived from the Subject Property's 882 leased parking spaces.⁹ Messner recognized the presence of these parking spaces, but did not include the parking income they generated in his NOI calculation.¹⁰

The appraisers also differed in their treatment of tenant improvements (TIs) and other leasing costs. Amundson estimated these costs at \$10.00 per square foot.¹¹ After subtracting these costs as expenses, Amundson concluded that the NOI for the Subject Property was \$1,885,166 for 2007, \$1,832,640 for 2008, and \$1,702,218 for 2009.¹² In contrast, Messner did not treat TIs as an appropriate operating expense when determining NOI for the Subject Property because the sales from which he derived his capitalization rate similarly did not subtract TIs from the property's operating income to arrive

⁹ Relators' Ex. 1, p. 35.

¹⁰ Resp't Ex. I, pp. 30, 75-94.

¹¹ Relators' Ex. 1, p. 38.

¹² Id. at pp. 43, 45, 47.

at NOI.¹³ Messner concluded that the NOI for the Subject Property was \$2,587,024 for 2007, \$2,633,554 for 2008, and \$2,327,414 for 2009.¹⁴

The appraisers also differed in their estimates of the appropriate capitalization rates. Amundson used capitalization rates of 8.00% for 2007 and 2008, and 9.00% for 2009.¹⁵ When adjusted to include taxes, these rates became 11.24339%, 11.16748%, and 12.24833% respectively.¹⁶ Messner used a capitalization rate of 7.00% for 2007.¹⁷ He increased this by 50 basis points to account for TIs and other leasing costs because he had excluded these costs from his calculation of NOI, thus resulting in a capitalization rate of 7.50% for 2007.¹⁸ Applying the trends found within the Korpacz survey, he determined that the appropriate capitalization rates were 7.25% for 2008 and 8.25% for 2009. When adjusted for taxation, these amounts became 10.74%, 10.42%, and 11.50% respectively.¹⁹ Further, because the roof of the Subject Property was repaired in 2010 at a cost of \$213,389, and a potential buyer in 2007, 2008, and 2009 would have anticipated this cost, Messner deducted

¹³ Resp't Ex. I, p. 87.

¹⁴ Id. at pp. 93, 94.

¹⁵ Relators' Ex. 1, p. 41.

¹⁶ Id. at pp. 43, 45, 47.

¹⁷ Resp't Ex. I, p. 90.

¹⁸ Id.

¹⁹ Id. at p. 92.

\$215,000 from his estimates of the Subject Property's final value for all three years.²⁰

The Tax Court examined the reports of both appraisers and listened to trial testimony regarding their appraisals. For the most part, the Tax Court found Messner's estimations to be more persuasive.²¹ The Tax Court also decided it was appropriate to include the revenue generated by parking, using the rental rates provided in Amundson's report.²² The Tax Court thus came to the conclusion that the Subject Property was worth \$26,164,000 in 2007, \$27,420,000 in 2008, and \$22,094,000 in 2009.²³

ARGUMENT

I. Standard of Review

While the Tax Court's legal conclusions are reviewed de novo, its factual findings are given deference and are only overturned when they are clearly erroneous. Continental Retail, LLC v. Cnty of Hennepin, --- N.W.2d ---, No. A11-0345, 2011 WL 3586180 (Minn. Aug. 17, 2011); Eden Prairie Mall v. Cnty. of Hennepin, 797 N.W.2d 186, 189 (Minn. 2011). No deference will be given to value determinations by the Tax Court if the Tax Court "has clearly misvalued the property or has failed to explain its reasoning." Continental

²⁰ Id.

²¹ RA Add-13-21.

²² Id. at Add-15-16.

²³ Id. at Add-25.

Retail, --- N.W.2d ---, No. A11-0345, 2011 WL 3586180 (Minn. Aug. 17, 2011).

A decision of the Tax Court will be found to be clearly erroneous if the decision is not reasonably supported by the evidence as a whole. Id. A clearly erroneous finding occurs when the Tax Court's decision results in the "definite and firm conviction that a mistake has been committed." Equitable Life Assurance Soc'y of U.S. v. Cnty. of Ramsey, 530 N.W.2d 544, 552 (Minn. 1995) (citations omitted).

II. The Tax Court's valuation should be affirmed 1) because it was based on the evidence, 2) because the Tax Court adequately explained its findings, and 3) because the Subject Property was not misvalued.

A Tax Court finding of value will be afforded deference when it is based on facts in the record, when the court provides an adequate explanation for its determinations, and when the court has not clearly misvalued the property in question. Eden Prairie, 797 N.W.2d at 192. Here, the Tax Court based every one of its findings on evidence presented during the trial and, throughout its decision, explained the reasons behind its conclusions. In doing so, the court arrived at a reasonable value for the property. Because the court's decision does not leave one with the "definite and firm conviction that a mistake has been committed," its ruling should be affirmed. Equitable Life, 530 N.W.2d at 552.

1. The Tax Court's findings were based on evidence presented by the appraisers and the court explained every step of its decision making process.

When coming to a conclusion about the value of a property, the Tax Court is not bound by the estimations of either appraiser. Eden Prairie, 797 N.W.2d at 193. Instead, the court may draw its own conclusions after evaluating the evidence presented at trial. Equitable Life, 530 N.W.2d at 558. See also Kmart Corp. v. Cnty. of Becker, 709 N.W.2d 238, 243 (Minn. 2006) (holding that the Tax Court did not err when it arrived at a different valuation than that expressed by either appraiser). A Tax Court may even come to a valuation higher than the submitted appraisals, as long as it “adequately explains its reasoning and its determination is supported by the factual record.” Eden Prairie, 797 N.W.2d at 194.

The method of determining value given the most weight by both appraisers in this case was the income capitalization approach.²⁴ Determining the value of a building from direct capitalization involves dividing the net operating income (NOI) of the property by its capitalization rate. Appraisal Institute, The Appraisal of Real Estate 501 (13th ed. 2008).²⁵

²⁴ Relators' Ex. 1, p.48; Resp't Ex. I, p.117.

²⁵ Though this edition was published in 2008, this authoritative reference work is a compilation of developing appraisal techniques and would encompass best practice appraisal methods that were in use in 2007. See Appraisal Institute, The Appraisal of Real Estate Forward. This edition has also been used as a reference in Relator's Brief. Relator's Brief, pp. 6, 10.

NOI is the “actual or anticipated net income that remains after all operating expenses are deducted from gross income, but before debt service and book depreciation are deducted.” Eden Prairie, 797 N.W.2d at 195 (citing The Appraisal of Real Estate 457). When the court is presented with differing expert testimony regarding sources of income, it must reconcile those differences using the evidence presented. Equitable Life, 530 N.W.2d at 558.

Here, the Tax Court was presented with very different expert opinions regarding the market rent of the Subject Property, the use of income derived from parking, the level of market expenses, the vacancy rate, whether tenant improvements should be accounted for when calculating NOI, and, finally, the appropriate capitalization rate. The Tax Court reconciled all of these disputes by examining the facts presented in the record and provided clear explanations of its reasoning.²⁶ Because they do not create the definite and

²⁶ RA Add-14 (“Based upon a comparison between the rents of the Subject Property and that of the other buildings in the neighborhood, we find Mr. Messner’s determinations . . . were more reasonable.”), 15 (“[T]here is nothing in the record to indicate that the comparable space . . . was superior to the Subject Property.”), 17 (“These figures are closer to Mr. Messner’s figures [t]herefore, we find the expense figures suggested by Respondent to be more representative”), 19 (“Respondent’s appraiser . . . did not include reserves for replacement as a separate expense because he adjusted his cap rate up 50 basis points to account for the reserves. . . . We find Mr. Messner’s approach more persuasive.”), 21 (“Based upon the evidence presented, we find Mr. Messner’s determination of cap rates to be more persuasive”), 23 (“We find Mr. Messner’s sales comparison approach to be more persuasive based upon several factors.”).

firm conviction it made a mistake, the Tax Court's valuations were not clearly erroneous and should be affirmed.

1.1. The Tax Court did not err in finding Messner's analysis of market rent more persuasive.

Income from rent must be derived from the market, taking into account the conditions and restrictions of the typical lease agreement. Eden Prairie, 797 N.W.2d at 195. Here, the Tax Court was presented with two different opinions of what constituted market rent for the Subject Property.²⁷ As the court noted, Amundson's estimation of market rent was much lower than the rent charged for neighboring buildings.²⁸ Despite Relators' contention that the Tax Court adopted Respondent's brief verbatim, the Tax Court rejected Respondent's argument that market rent should be based on the terms of the current lease.²⁹ Instead, it relied on Messner's estimations, holding that the market level of rent for the office space was \$17 per square foot in 2007, \$17.50 per square foot in 2008, and \$16.74 per square foot in 2009.³⁰

The Tax Court found Amundson's figures for rent for storage space unpersuasive because he did not compare the actual features of the Subject Property's storage space with other properties.³¹ Further, the Tax Court

²⁷ RA Add-14.

²⁸ Id. at Add-14 n.10.

²⁹ Id. at Add-14.

³⁰ Id.; Resp't Ex. I, pp. 79-82.

³¹ RA Add-15.

found that Amundson had failed to account for the rising cost of storage space in the Subject Property's neighborhood.³² The Tax Court again rejected the Respondent's arguments regarding market rent and instead used Messner's estimated rent in deciding that the market value of rent for storage space was \$6.00 per square foot.³³

1.2. The Tax Court did not err when it included income derived from parking.

Amundson's report identified 882 parking spaces that rented out at \$25 per month per space (\$300 annually) in 2007 and 2008, and at \$30 per month per space (\$360 annually) in 2009.³⁴ Amundson then estimated the market value of the income from these parking spots at \$200,000 for 2007 and 2008, and \$250,000 for 2009.³⁵ Amundson claimed, and Relators argue, that these values were projections based on the parking income for the previous year.³⁶

Relying on the previous year's income was an incorrect approach for two reasons. First, "the value of rentable space is estimated using market rent levels." Eden Prairie, 797 N.W.2d at 195. This value is to be determined through extensive market research. Id. Here, Amundson made no attempt in his report to compare the income derived from the parking spaces to similarly

³² Id.

³³ Id.; Resp't Ex. I, pp. 79-82.

³⁴ Relators' Ex. 1, p. 35.

³⁵ Id. at pp. 42, 44, 46.

³⁶ Id. at p. 35; Relators' Brief, pp. 19-21.

situated properties. Second, Amundson was projecting figures from the previous year's actual revenue, revenue that already reflected any actual vacancy. Amundson then applied vacancy percentages to the parking revenue a second time when calculating the NOI of the Subject Property.³⁷

The Tax Court properly considered the value added to the Subject Property by the adjacent parking lots because, by operation of an easement, the income from the parking lots was income to the Subject Property. Alvin v. Johnson, 63 N.W.2d 22, 25 (Minn. 1954) (“[I]n assessing the plaintiff’s property, it was the assessor’s duty to take into consideration the additional value the property had by reason of the easement appurtenant.”). Because it found Amundson’s final estimation of parking income unpersuasive, the Tax Court chose to derive its own estimation of the market value of parking income. To do so, the Tax Court used the contract rent for each parking space as provided by Amundson.³⁸ This was a reasonable method of determining the market value of the parking income, especially given the lack of other data to assist the court in this process. See The Appraisal of Real Estate 453 (“[Market rent] is indicated by the current rents that are either paid or asked for comparable space with the same division of expenses as of the date of the appraisal.”) (emphasis added). By multiplying the annual amount of these

³⁷ Relators’ Ex. 1, pp. 42, 44, 46.

³⁸ RA Add-15.

rates by the number of spaces, the Tax Court determined that the market value of the parking income was \$264,000 in 2007 and 2008, and \$317,520 in 2009.³⁹ As the final figures will show, the Tax Court chose to use \$264,000 across the board for evaluating parking income. Because the addition of parking income was supported by the evidence, the Tax Court did not err by including it in its analysis of the Subject Property's income. See Kmart, 709 N.W.2d at 243 (holding that the Tax Court did not err when it used evidence presented by Kmart's appraiser to arrive at a final value higher than that reached by the same appraiser). See also Weed v. Cnty. of Fillmore, 630 N.W.2d 419, 425 (Minn. 2001) (holding that the Tax Court properly exercised its discretion by ignoring factors that may have reduced the value of the property when the relator failed to introduce such evidence at trial).

Relators have mischaracterized the Tax Court's position regarding parking income in three major ways. First, Relators state that "[t]he Tax Court rejected both appraisers' analysis and opinions about parking income."⁴⁰ This is simply not true. While Messner left parking income out of his direct calculations, he never explicitly rejected it as a legitimate contributor to the Subject Property's value.⁴¹ Second, Relators criticize the Tax Court for adopting parking income as part of NOI without accounting for

³⁹ Id.

⁴⁰ Relators' Brief, p. 19.

⁴¹ Resp't Ex. I. pp. 1, 5, 113.

vacancies.⁴² This is also not true. The Tax Court applied a market vacancy rate to potential gross income, a figure which included parking income.

Finally, Relators reverse the Tax Court’s logic when they argue that the court assumed that Amundson’s figures came from applying a 10% vacancy rate to the potential parking income.⁴³ In fact, the Tax Court correctly stated that “Amundson used parking income of \$200,000 for 2007, \$250,000 for 2008, and \$260,000 for 2009 and *then* applied a 10% vacancy rate.”⁴⁴

The following chart indicates the Tax Court’s estimation of Potential Gross Income after accounting for rent and parking income:

	2007	2008	2009
<u>Rent for Office Space</u> ⁴⁵ 250,695 SF x 2007: \$17.00 per SF 2008: \$17.50 per SF 2009: \$16.75 per SF	\$4,261,815	\$4,387,163	\$4,199,141
<u>Rent for Storage Space</u> ⁴⁶ 29,477 SF * \$6 per SF	+ \$176,862	+ \$176,862	+ \$176,862
Parking Income	+\$264,600	+\$264,600	+\$264,600
Potential Gross Income	\$4,703,277	\$4,828,625	\$4,640,603

⁴² Relators’ Brief, p. 21.

⁴³ Id. at p. 20 n.7.

⁴⁴ RA Add-15-16 (emphasis added).

⁴⁵ Resp’t Ex. I, pp. 79-82.

⁴⁶ Id.

The Tax Court's analysis is clearly supported by the testimony and the evidence presented at trial.

1.3. The Tax Court did not err when it adopted Messner's analysis for market vacancy and expenses.

The appraisers differed in their estimations of the market vacancies for the Subject Property. Amundson identified market vacancy at 10% based on a comparison with other properties.⁴⁷ Messner, on the other hand, estimated market vacancy at 7% in 2007 and 2008, and 10% in 2009.⁴⁸ Messner found that these lower rates were justified by the fact the property was located in a submarket characterized by long-term leases that result in little to no vacancy.⁴⁹ He also explained that government-occupied office buildings tend to have historically low levels of vacancies.⁵⁰ The Tax Court explained that it agreed with this argument and thereby adopted Messner's vacancy rates.⁵¹

Similarly, the appraisers differed when calculating the market expenses for the Subject Property. Amundson used statistics provided by BOMA and NorthMarq to evaluate market expenses while Messner based his analysis on historical data from the Subject Property.⁵² The Tax Court examined the BOMA statistics for market expenses, which included real estate taxes, and

⁴⁷ Relators' Ex. 1, p. 36.

⁴⁸ Resp't Ex. I, p. 85.

⁴⁹ Id. at p. 84.

⁵⁰ Id.

⁵¹ RA Add-16.

⁵² Relators' Ex. 1, p. 37; Resp't Ex. I, p. 86.

then subtracted the average real estate taxes for those three years.⁵³ Because the resulting numbers more closely matched Messner's estimations of market expenses, the Tax Court adopted Messner's estimations as its own and found that the market operating expenses per square foot were \$5.50 for 2007 and \$5.75 for 2008 and 2009.⁵⁴

Thus, in reconciling the different estimates of market vacancy and market expenses, the Tax Court properly exercised its discretion to find one appraiser's estimates more persuasive than the other. Equitable Life, 530 N.W.2d at 552 (stating that Tax Courts deserve deference given the inexact nature of real estate appraisal). See also Weed, 630 N.W.2d at 425 (holding that the Tax Court did not abuse its discretion when it found the county's appraiser's estimates more persuasive than the relator's personal valuation).

1.4. The Tax Court did not clearly err when it excluded TIs from NOI.

To determine whether TIs should be included in calculating NOI when using the income capitalization approach, an appraiser must examine the market in order to determine whether the market indicates that it is usual for these expenses to be deducted. See Eden Prairie, 797 N.W.2d at 196 (holding that appraisers must conduct market research before subtracting tenant improvement allowances from rent). While TIs may be considered

⁵³ RA Add-17.

⁵⁴ Id.

above-the-line expenses that affect NOI, “[m]ore often, they are treated as below-the-line expenses.”The Appraisal of Real Estate 480.

The appraisers here differed dramatically on whether to factor TIs into NOI. Amundson estimated the TIs for the Subject Property at \$10.00 per square foot for all three years and deducted that amount as an operating expense.⁵⁵ Messner left TIs out of his NOI calculation completely.⁵⁶ In doing so, he explained that the comparable properties used to develop his capitalization rates also excluded TIs from the NOI calculation.⁵⁷ Leasing costs were similarly excluded from Messner’s NOI analysis.⁵⁸ Instead, Messner added 50 basis points to the capitalization rate to account for leasing costs and TIs.⁵⁹

The Tax Court disapproved of including TIs as a direct deduction from income. This was in part because \$13 million had been spent on building improvements in 2005 and 2006, thereby decreasing the expectation of a potential buyer that it would immediately need to spend money on further improvements.⁶⁰ Further, TIs are driven by the market. The Appraisal of Real Estate 480. Here, as the Tax Court had noted, the Subject Property

⁵⁵ Relators’ Ex. 1, pp. 42, 44, 46.

⁵⁶ Resp’t Ex. I, p. 87.

⁵⁷ Id.

⁵⁸ Id.

⁵⁹ Relators’ Ex. 1, p. 90.

⁶⁰ RA Add-18-19.

benefited from a ten year lease and it belonged to a submarket characterized by extremely low vacancies.⁶¹ Thus, the Subject Property is far less affected by the market pressures that would otherwise drive TIs.

The Tax Court, however, did not completely exclude TIs from its valuation, despite Relators' frequent statements to the contrary.⁶² Instead, the Tax Court utilized Messner's capitalization rates as adjusted for TIs and leasing costs, explicitly recognizing that these capitalization rates "account for those expenses which were not deducted as expenses in the surveys upon which he relied."⁶³ The Tax Court thus chose a method of analyzing TIs based on the evidence presented. Given its explanation of its reasoning along with its use of modern appraisal techniques as described in the latest edition of The Appraisal of Real Estate, Tax Court did not clearly err when it excluded TIs from its estimation of the Subject Property's NOI.

Relators make much out of the Tax Court's previous decision, which amortized renovation expenses over a ten year period.⁶⁴ This comparison is unpersuasive because those past renovations would only affect the income expectations of a potential buyer looking to purchase the Subject Property *before* the renovations were complete. Renovation expenses do not decrease

⁶¹ Id. at Add-24.

⁶² See Relators' Brief, pp. 14, 15, 17.

⁶³ RA Add-20.

⁶⁴ Relators' Brief 14-16.

the rental income which a potential buyer expects to receive from the Subject Property when the sale is made immediately *after* the renovations are finished. The assessment dates at issue here were immediately *after* the renovations were completed.

Further, the Tax Court's prior methods of determining value are not binding on a determination of current value when circumstances have significantly changed since the last Tax Court valuation. SLC TB Acquisition L.L.C. v. Cnty. of Murray, Nos. C2-03-121, C4-03-248, 2004 WL 1459339, at *8 (Minn. Tax Ct. June 15, 2004) (holding that prior Tax Court valuations were inapplicable to current valuations because the property had undergone major renovations since the last valuation and had sold for substantially more than previous assessment amounts). Here, the Subject Property has benefited from a \$13 million renovation project and has sold for an amount substantially more than the prior determinations of value.⁶⁵ These substantial changes to the Subject Property render immaterial the Tax Court's prior methods of determining value.

⁶⁵ The Respondent recognizes that this sale included more than the Subject Property, but this amount still justifies the Tax Court's decision to vary its valuation techniques.

The Tax Court's analysis of NOI can thus be summarized as follows:

	2007	2008	2009
Potential Gross Income	\$4,703,277	\$4,828,625	\$4,640,603
<u>Less Market Vacancy</u> ⁶⁶ 2007 and 2008: 7% of potential gross income 2009: 10% of potential gross income	-\$329,229	-\$338,004	-\$464,060
<u>Operating Expenses</u> ⁶⁷ 280,172 SF x 2007: \$5.50 per SF 2008 and 2009: \$5.75 per SF	-\$1,540,946	-\$1,610,989	-\$1,610,989
Net Operating Income	\$2,833,102	\$2,879,632	\$2,565,554

1.5. The Tax Court did not clearly err by choosing a capitalization rate that accurately reflected the comparative data and the unique features of the Subject Property's submarket.

Deriving capitalization rates from comparable sales is the preferred technique when such data is available. The Appraisal of Real Estate 501. The overall level of risk associated with each comparable should be similar, and appraisers should examine the credit rating of the tenants, the market conditions of the particular property, the stability of the property's income stream, the level of investment in the property by the tenant, and the property's upside or downside potential. The Appraisal of Real Estate 502.

⁶⁶ Resp't Ex. I, p. 85.

⁶⁷ Id. at p. 87.

The appraisers here came to different estimations of the Subject Property's capitalization rates. Amundson based his capitalization rates on several national surveys.⁶⁸ During testimony, though, Amundson admitted that non-comparable buildings were used in those surveys.⁶⁹ Messner also used national surveys to estimate the capitalization rate, but he adjusted the capitalization rate to reflect the fact that the Subject Property was located in a submarket of properties occupied by long-term tenants and with little to no vacancy.⁷⁰ Messner further compared his capitalization rate to a survey which examined property sold in the Twin Cities market.⁷¹ After arriving at an appropriate capitalization rate, Messner added 50 basis points to account for costs that were not included in the calculation of NOI.⁷² This methodology is consistent with the imperative that "the appraiser analyze comparable sales and derive their capitalization rates in the same manner used to analyze the subject property and capitalize its income." The Appraisal of Real Estate 503.

The Tax Court found that Messner's capitalization rates were more persuasive.⁷³ The court recognized that Amundson had failed to account for

⁶⁸ Relators' Ex. 1, pp. 39-41.

⁶⁹ Trial Tr., pp. 117-18, 120-21, Dec. 6, 2010.

⁷⁰ Resp't Ex. I, pp. 88-90.

⁷¹ Id. at p. 91.

⁷² Id. at p. 90; Trial Tr., pp. 365-70.

⁷³ RA Add-21.

the unique market in which the Subject Property was located, and that he had ignored a downward trend in capitalization rates between 2007 and 2008.⁷⁴ The Tax Court also noted that his capitalization rate of 9% was higher than any of those presented in the relevant surveys.⁷⁵ Though the Tax Court rejected Respondent's arguments that Amundson had failed to consider a hypothetical institutional buyer in his analysis, it decided that Amundson's figures were unreliable.⁷⁶ Thus, the Tax Court used Messner's capitalization rate because it more closely matched the evidence presented.⁷⁷

Relators accuse Messner of failing to determine the market rate of TIs and other costs when choosing the factor by which to increase the capitalization rate.⁷⁸ Messner, however, derived this increase by comparing the difference in capitalization rates from market sales when these expenses were included in NOI and the capitalization rates when they were not.⁷⁹ This is the type of "objective observation of the collective actions of the market" which forms the basis of any opinion on market value. See The Appraisal of Real Estate 23.

The Tax Court used Messner's capitalization rates that included the tax rate for each year. After decreasing the net value of the building by the cost of

⁷⁴ Id. at Add-20-21.

⁷⁵ Id. at Add-21.

⁷⁶ Id. at Add-20.

⁷⁷ Id. at Add-21.

⁷⁸ Relators' Brief, p. 14 n.6.

⁷⁹ Resp't Ex. I, p. 90.

the roof repairs conducted at the end of 2009, the Tax Court came to the following conclusions regarding the value of the building:

	2007	2008	2009
Net Operating Income	\$2,833,102	\$2,879,632	\$2,565,554
Capitalization Rate ⁸⁰	10.74%	10.42%	11.50%
Subtotal (NOI / Capitalization Rate)	\$26,378,976	\$27,635,624	\$22,309,165
Less Roof Expenses ⁸¹	-\$215,000	-\$215,000	-\$215,000
Total Value	\$26,163,976	\$27,420,624	\$22,094,165

The Tax Court then rounded these figures to \$26,164,000 for 2007, \$27,420,000 for 2008, and \$22,094,000 for 2009.⁸² As explained above, every step of its findings was based on evidence in the record, was consistent with appropriate real estate appraisal techniques, and was clearly explained throughout. Even though its valuations were higher than the estimates of either appraiser, it was well within the Tax Court's discretion to come to its own conclusions regarding the Subject Property's value. See Eden Prairie, 797 N.W.2d at 194. While some may disagree with the Tax Court's exact valuations, its reasoned logic and thorough explanations do not create the definite and firm conviction that the court made a mistake.

⁸⁰ Id. at p. 92.

⁸¹ Id.

⁸² RA Add-24.

2. Despite the difference between the current and prior Tax Court valuations, there is no evidence that shows the Tax Court misvalued the Subject Property.

If the Tax Court based its findings on evidence presented in the record, correctly applied the law, and took pains to explain the logic behind its decisions, its findings should be affirmed “unless the Tax Court has either overvalued or undervalued the subject property.” Equitable Life, 530 N.W.2d at 552. A property’s market value should be determined from the view point of a generic, objective buyer at a private sale. Id. at 555. To ensure that it did not misvalue the Subject Property, the Tax Court examined three other indications of value: (1) the sales comparison approach to determining value; (2) the Tax Court’s prior determination of value; and (3) the 2007 sale price of the Subject Property. None of these indicate that the Tax Court clearly misvalued the Subject Property for 2007, 2008, or 2009.

2.1. Messner’s sales comparison approach supported the Tax Court’s determinations of the Subject Property’s value.

To ensure that one has not misvalued property, multiple approaches to deriving value can be used to support conclusions of value. The Appraisal of Real Estate 141. Here, the Tax Court used a sales comparison approach to determine whether it may have overvalued or undervalued the Subject Property.⁸³

⁸³ Id. at Add-21-23.

The Tax Court examined Amundson's figures first, but found them unpersuasive for several reasons. First, Amundson's comparable properties involved large vacancies, a trait not shared by the Subject Property.⁸⁴ Second, Amundson did not include specific numerical adjustments in his grid to account for market conditions, location, or effective age.⁸⁵ Finally, Amundson failed to give an adequate explanation of his analysis, a requirement of using the sales comparison approach effectively. See The Appraisal of Real Estate 304 ("It is imperative that the appraiser identify and analyze the strengths and weaknesses of the quantity and quality of the data compiled.").

Instead, the Tax Court chose to rely on Messner's figures, which included a study of buildings with comparably light vacancies, along with an extensive explanation of his analysis of the sales.⁸⁶ Using the sales comparison approach, Messner determined the ranges of value for the Subject Property to be from \$24,750,000 to \$26,400,000 for 2007 and 2008, and \$21,450,000 to \$23,100,000 for 2009.⁸⁷ The Tax Court's valuations for 2007 and 2009 fall within these ranges and the valuation for 2008 is only 4% higher than the top end of Messner's range. Thus, comparisons between the Tax Court's final valuations to those derived from Messner's sales comparison approach should

⁸⁴ Trial Tr., pp. 166-68, 174, 182, 209-10, Dec. 6-7, 2010; RA Add-23.

⁸⁵ RA Add-23; See Relators' Ex. 1, p. 26.

⁸⁶ RA Add-23.

⁸⁷ Resp't Ex. I, p. 114.

not result in a definite and firm conviction that the Tax Court made a mistake.

2.2. The Tax Court's prior valuations are not persuasive evidence of the Subject Property's current value.

Relators contend that the Tax Court's earlier valuation of the Subject Property demonstrates that the Tax Court misvalued the Subject Property for 2007 through 2009.⁸⁸ Relators are mistaken in believing this comparison should be persuasive, however, since it assumes incorrectly that prior Tax Court valuations of the property are always determinative when estimating market values for subsequent years. Instead, prior valuations are of little consequence when the property has subsequently undergone substantial changes, including extensive renovations. SLC TB Acquisition, 2004 WL 1459339, at *8. Here, the Tax Court found that the substantial changes to the Subject Property, including a major renovation and changes in market conditions, had rendered its prior valuations unhelpful in determining current value.⁸⁹

Relators argue that the expected costs for the 2005–2007 renovation costs were factored into the prior valuation of the Subject Property and, at that time, the Subject Property was assigned a lower value.⁹⁰ In 2005, though, a

⁸⁸ Relators' Brief, pp. 28-31.

⁸⁹ RA Add-24-25.

⁹⁰ Relator's Brief, p. 29.

potential buyer would have considered the cost of planned renovations in expectations of net rental income, thus lowering the market value of the building at that time. A potential buyer in 2007 would not have anticipated the same costs of renovation. When substantial renovations have occurred, one would expect a later valuation to be higher on a date closely following the completion of the renovations.

Relators also contend that the Tax Court had determined in its prior ruling that these renovations only added \$4 million to the value of the Subject Property and that the remaining \$9 million only had value for the tenant.⁹¹ This contention has no basis in the record. In addressing these renovation costs, the Tax Court in the earlier case merely found that such expenses should be handled *after* calculating NOI and that a lump sum deduction for infrequent tenant improvements would distort valuation by the direct income capitalization method. Meritex v. Cnty. of Ramsey, No. CX-06-4506, 2009 WL 2366285, at *8 (Minn. Tax Ct. July 24, 2009). Nowhere in the Tax Court's order is there some apportionment of the renovation's value between the tenant and the fee simple value of the Subject Property.

Relators further argue that the Tax Court did not correctly analyze the effects of market pressure on the value of the Subject Property.⁹² The Tax

⁹¹ Id.

⁹² Id. at pp. 30-31.

Court was presented with evidence from both appraisers regarding trends in the office market. Amundson testified that the area had stabilized regarding growth.⁹³ Messner found that the Twin Cities office market had strengthened after 2005 and Messner's calculations of market rent reflected these market pressures.⁹⁴ Here, the Tax Court properly exercised its discretion when it found one appraisal more persuasive than another. See Weed, 630 N.W.2d at 425.

2.3. The Tax Court appropriately considered the 2007 sale price but did not rely on it for its determination of value.

Finally, the Tax Court considered the sale price of the Subject Property in 2007 to determine if it had misvalued the property.⁹⁵ At that time, the Subject Property, when combined with seven parcels containing parking lots, was sold for \$36,000,000.⁹⁶ Despite the Relators' protests, it is helpful to consider the previous sale prices of real estate when determining the property's current market value. The Appraisal of Real Estate 304 ("[P]rior sales of the Subject Property must be considered in market value appraisals."). The Tax Court did not clearly err when it recognized that the Subject Property had sold along with other property for \$8,580,000 more than the Tax Court's highest valuation. However, given the array of evidence

⁹³ Relator's Ex. 1, pp. 9-10.

⁹⁴ Resp't Ex. I, pp. 23-25, 79-80.

⁹⁵ RA Add-24.

⁹⁶ Id.

supporting its findings, the 2007 sale price was entirely unessential to the Tax Court's final determination of value.

CONCLUSION

As it explained throughout its order, the Tax Court based its conclusions of value on the evidence presented and upon proper application of the law. Because there is no indication that the Tax Court clearly erred in determining the value of the Subject Property, the Tax Court's decision should be affirmed in its entirety.

Respectfully submitted,

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Dated: August 31, 2011

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STATE OF MINNESOTA

IN SUPREME COURT

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Relators,

CERTIFICATION OF BRIEF LENGTH

v.

County of Ramsey,

Supreme Court No. A11-1014

Respondent.

I hereby certify that this brief conforms to the requirements of Minn. R. Civ. App. P. 132.01, subds. 1 and 3, for a brief produced with a proportional font. The length of this brief is 6,677 words. This brief was prepared using Microsoft Word 2007.

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